

State of Michigan

Biennial Evaluation of the Internal Control Structure (ICS) in Effect During the Two-Year Period Ended September 30, 2004

The Management and Budget Act (Sections 18.1483 – 18.489 of the Michigan Compiled Laws) requires a biennial evaluation of each department's internal control structure¹. Results of these evaluations, including a description of any material weaknesses identified, and plans and time schedules for correcting them, must be reported by the department director to the Governor, Auditor General, Legislature, the State Budget Officer/Department of Management and Budget (DMB) Director. The current biennial cycle ends September 30, 2004 with the reports due by May 1, 2005. Examples of sample reports are included in *Administrative Guide to State Government* (procedure 1270.01).

In December of 1999, the State Budget Office's, Office of Financial Management (OFM) issued guidance for conducting evaluations of departmental internal controls. This guidance, formally titled *Evaluation of Internal Controls: A General Framework and System of Reporting* ([doc](#)) ([pdf](#)), represents a comprehensive revision to the guidance last issued in 1990. The revised guidance incorporates concepts set forth in a widely accepted internal control framework entitled "*Internal Control - Integrated Framework*" - prepared by the "COSO" (Committee of Sponsoring Organizations of the Treadway Commission- the federally sponsored group responsible for development of the framework).

This document contains instructions for using the referenced evaluation worksheets in conducting evaluations of a department's internal control structure. The worksheets were constructed using concepts presented in the general framework guidance. Departments should use these tools, or alternative evaluation tools, to evaluate and document their internal control structure. Use of the referenced tool sets should result in a substantive, effective evaluation of your department's internal control structure. See the section "Reference to Evaluation Tools" in OFM's general framework for considerations when selecting / using appropriate evaluation tools.

The worksheets referred to in these instructions address each component of internal control: Control Environment, Risk Assessment, Control Activities, Information & Communication, and Monitoring.

The guidance for evaluating internal controls focuses attention on departmental "activities" that contribute towards achievement of their missions and underlying objectives. An "activity" may be defined as one or several organizational components that seek to achieve common business objectives. Alternatively, the activity may correlate with a core business process that "cuts across" multiple activities (i.e., support functions including administrative activities, human resources, and information technology).

Management responsible for achievement of objectives in each of the department's identified activities should complete their evaluations in accordance with the guidelines issued by OFM. Departmental evaluations are **not** intended to assess opportunities for operational improvements such as staff additions, automation enhancements or other resource increases. Those are considered annually as part of the executive budget process and are not to be included in the biennial evaluation process. If material weaknesses (as defined in the internal control guidance issued by OFM) are identified that require additional resources to control, the department should prepare corrective action plans redirecting existing resources, including substantive evidence and quantifiable operational impact statements resulting from resource reallocation.

These new tools highlight the importance of "soft" control activities; this differs from traditional internal control assessment tools, such as those provided by OFM for prior evaluations. "Soft" controls are intangibles that management emphasizes to direct the organization, which includes integrity, ethical values, communication, philosophy, operating style, organizational commitment to competence, and the understanding and management of risk.

Evaluation worksheets are in a narrative format requiring written responses. Generally, responses will not be "yes" or "no," but rather information on how "activity managers" address each item included on the worksheets. The evaluator should provide detailed information about management's internal control structure and provide documentation to support their conclusions.

Departmental management responsible for *financial management activities* should complete the evaluation of internal control structure over accounting activities and financial practices. The approach for evaluating internal controls over *non-financial activities* is identical to that used for evaluating internal controls over financial activities – however, the activity level objectives will differ. Evaluators of each departmental activity should use the worksheets to identify, document, and evaluate the risks and controls related to achievement of the objectives it seeks to attain.

Space is provided at the end of each worksheet for appropriate agency personnel to "**Certify**" his/her overall evaluation conclusions. The person responsible for the conclusions should sign the certification, either the DSO, in the case of a department-wide evaluation, or the activity level manager, for activity level evaluations. Certification attests to the sufficiency or effectiveness of the respective activity's internal control structure. Departments should submit a description of corrective action plans and time frames for addressing material weaknesses identified in connection with this biennial evaluation.

Departments may use either hardcopy or electronic worksheets to document evaluation responses and conclusions. Electronic worksheets are available for download via OFM's web site and can be customized to allow for additional space for documenting the evaluation and associated conclusions. Attach additional narratives/explanations to the worksheets to further document how items apply to the department. If applicable formal (written) policies or procedures are mentioned, identify/reference such policies. If informal policies, procedures or practices are mentioned as representing controls, document these and provide copies along with the completed evaluation worksheets.

Worksheets and instructions for documenting [Information Technology](#) related controls can also be found on the OFM website.

¹ The Management and Budget Act uses the term Internal Accounting and Administrative Control System. This term can be used interchangeably with Internal Control, Internal Control Structure, or System of Internal Control - all are comparable.

Worksheet Instructions for:
Evaluating the Control Environment Component ([doc](#)) ([pdf](#)) of the ICS
and
Evaluating the Information and Communication Component ([doc](#)) ([pdf](#)) of the ICS

These worksheets focus on common factors (objectives and risks) relevant to the Control Environment and Information and Communication components of the department's overall internal control structure. These worksheets should be used to conduct evaluations of components at the department-wide perspective and, where applicable, at the activity level. For example, activity level management may not be concerned with the objective that all departmental objectives are consistent and interrelated. However, activity level managers should

be knowledgeable about the effectiveness of all internal control components and must evaluate elements of the internal control component for which they are responsible.

General Instructions and Considerations

Respond to each item from the perspective of the activity manager completing the evaluation. If this is not practical, address the item from the perspective of, or with regard to the department as a whole. Focus your responses on policies, practices or procedures of the individual activity or identify departmental policies, procedures or practices that impact/apply to the activity being evaluated. Listed below each item are examples of subsidiary issues to illustrate the types of issues to consider; many other issues will likely be relevant.

Use the second column, "Description/Comments on Policies/Procedures/Practices," to provide comments and a detailed description of the strengths and weaknesses of existing control activities employed to achieve objectives / criteria identified in the first column.

At the end of each section, space is provided to record a conclusion on the effectiveness of related controls and management's proposed actions (i.e., corrective actions) to address identified control weaknesses.

Worksheet Instructions for:

Evaluating the Risks, Control Activities, and Monitoring Components of the ICS (for non-financial activities) ([doc](#)) ([pdf](#))

Each activity level manager should use this worksheet to evaluate and document internal controls that contribute towards the achievement of activity level objectives. Results of activity level evaluations should be considered when performing the department's overall evaluation of internal controls that contribute towards the achievement of department-wide objectives, using the approach presented in this worksheet.

General Instructions and Considerations

For purposes of complying with the biennial evaluation requirements, evaluators should focus the evaluation and documentation on **significant** activity level and/or department-wide objectives being evaluated. Significance may be based upon the fiscal size of the activity (i.e., budget/expenditures) and the degree of inherent risks in the activity / process (e.g., cash collections, inventory susceptible to theft, confidentiality of information, degree of potential political/legislative or media interest, etc.). Management should evaluate the internal control structure over the non-significant, incidental or non-critical activities/objectives during the course of normal operations – not necessarily to support the biennial evaluation requirements.

Typically, personnel responsible for managing non-financial activities will not be requested to complete separate worksheets for internal controls over financial/accounting practices – this is the responsibility of your department's financial management. When an activity level objective is financial in nature, and much of the control is the responsibility of the department's financial management personnel, the evaluator should indicate the importance of the objective, and note that they are relying on the appropriate personnel responsible for controlling the associated risks. Furthermore, the evaluator should consult with the responsible financial management to gain an understanding of how the (financial management) risks are mitigated, and consider implementing additional control activities by either management of the activity being evaluated or the financial management personnel. Top leadership should be involved in decisions on where (i.e., under what manager's responsibility) controls should be enhanced / added.

Specific Instructions

- Activity Level Objective (Column 1) - Identify the significant activity level objectives being evaluated. The worksheet includes space for 6 objectives for illustrative purposes (more or fewer may be evaluated, based upon the evaluator's judgment as to significance). **Examples** of activity level objectives include completing customer projects in a timely manner; ensuring services provided meet quality standards; ensuring work environments/conditions comply with laws, regulations.
- Risk Factors (Column 2) - Identify risks associated with each significant activity level objective. Risks may be identified as the result of answering the following types of questions: 1) "What is the potential result of not efficiently/effectively performing control activities to meet a specific operating objective?" or 2) "What are potential effects on reliability of financial reporting, compliance with laws and regulations, safeguarding of program assets, efficient use of program resources?". **Examples** of risks include failure to complete customer projects timely, providing services that do not meet established quality standards, work environment/conditions that violate applicable laws, regulations, etc.
- Risk Rating (Column 3) - Assigning a risk rating is helpful in prioritizing. If a risk is inherently low, less time should be spent thinking it through – and fewer resources spent managing it. High risks demand more attention.

To assess a risk, we should consider both the:

- **Severity/Significance** – How serious would it be if the effect were to occur?
What's the impact?
- **Frequency/Likelihood** – How likely is it to occur?

For these purposes, a reasonable rating of high, medium, or low is sufficiently precise. For most risks, a single rating is enough. For some, a split rating (e.g. high significance, low likelihood) might be meaningful.

- Actions / Control Activities (Column 4) - Identify control activities (policies, procedures or practices) that exist within the activity that mitigate identified risks. Be as detailed as possible; describe specific control activities that do not represent formal policies/procedures or are not otherwise documented. **Examples** of control activities include production/project management, customer satisfaction evaluation procedures, cost containment controls (labor and materials), procedures for accumulating administrative and related federal program costs, management/supervisory review of various processes, quality assurance monitoring procedures, etc.

Generally, identify control activities that:

- Provide separation of duties and responsibilities among employees.
- Limit access to State resources to authorized personnel requiring access within scope of assigned duties.
- Assure appropriate authorizations and record-keeping procedures are used to control assets, liabilities, revenues, and expenditures.
- Assure established policies and procedures are followed in performance of assigned functions.
- Ensure personnel are qualified and maintain a sufficient level of competency.
- Ensure activity level objectives are accomplished efficiently.

- Monitoring (Column 5) - Identify monitoring activities used by the activity manager to ensure established internal controls are operating and effectively address identified risks. Include results of testing conducted under the direction of management as evidence to support conclusions. Provide detailed responses; describe specific monitoring activities that do not represent formal policies/procedures or are not otherwise documented.
- Conclusions (Column 6) - Record a conclusion on the sufficiency/effectiveness of existing internal controls, and proposed actions (i.e., corrective actions) to address internal control weaknesses. Monitoring activities are the key factor in concluding about the effectiveness of control activities. It is difficult for an activity manager to reach conclusions about the effectiveness of control procedures without first implementing appropriate monitoring activities.

Worksheet Instructions for:
Evaluating the Risks, Control Activities, and Monitoring Components of the ICS
Associated with Financial Management Activities ([doc](#)) ([pdf](#))

Typically, management responsible for the department's overall financial operations will complete this worksheet. The information resulting from this evaluation should be shared with all personnel in the department (e.g., other activity managers) to strengthen an overall understanding and implementation of controls over financial activities, and to minimize duplication of effort.

Specific Instructions

- Objectives (Column 1) - Identifies operational, financial reporting, and compliance objectives related to financial/accounting activities.
- Control Objective Type (Column 2) – Indicates the nature of the objective identified in column 1, in relation to the broad objectives achieved through an effective internal control structure. This column is useful in summarizing overall conclusions about the effectiveness of the internal control structure over financial management activities. The broad categories of objectives include:

"O" - Operational effectiveness and efficiency in the use of departmental resources.
 "F" - Reliable preparation of financial statements and schedules.
 "C" - Compliance with applicable laws, regulations, and management directives.
- Risk Analysis (Column 3) - Identifies common risks associated with the objectives; answers questions such as: ("What is the potential result of not having proper controls over financial/accounting transactions?" "What are potential effects on reliability of financial reporting, compliance with laws and regulations, and safeguarding of program assets?"). The risk analysis should consider the significance of the risk (i.e., potential adverse effects) and the likelihood or frequency of its occurrence. This leads logically into the analysis of how management should manage the risk, which is documented in subsequent column #4.
- Risk Rating (Column 4) - Assigning a risk rating is helpful in prioritizing. If a risk is inherently low, less time should be spent thinking it through – and fewer resources spent managing it. High risks demand more attention.

To assess a risk, we should consider both the:

- **Severity/Significance** – How serious would it be if the effect were to occur?
What's the impact?
- **Frequency/Likelihood** – How likely is it to occur?

For these purposes, a reasonable rating of high, medium, or low is sufficiently precise. For most risks, a single rating is enough. For some, a split rating (e.g. high significance, low likelihood) might be meaningful.

- *Actions / Control Activities (Column 5)* - Identifies actions/control activities (policies, procedures or practices) in place to minimize risks and contribute towards achievement of the objective identified in column #1. Provide detailed responses; describe specific control practices that do not represent formal policies/procedures or are not otherwise documented by the activity.

Generally, identify control activities that:

- Provide separation of duties and responsibilities among employees.
 - Limit access to State resources to authorized personnel requiring access within scope of assigned duties.
 - Assure appropriate authorizations and record-keeping procedures are used to control assets, liabilities, revenues, and expenditures.
 - Assure established policies and procedures are followed in performance of assigned functions.
 - Ensure personnel are qualified and maintain a sufficient level of competency.
 - Ensure program objectives are accomplished efficiently.
- *Monitoring (Column 6)* - Identify monitoring activities in place to ensure established internal controls are operating and effectively address identified risks. Include results of testing conducted under the direction of management as evidence to support conclusions. Provide detailed responses; describe specific monitoring activities that do not represent formal policies/procedures or are not otherwise documented.
- *Conclusions (Column 7)* - Record a conclusion on the sufficiency/effectiveness of existing internal controls, and proposed actions (i.e., corrective actions) to address internal control weaknesses. Monitoring activities are the key factor in concluding about the effectiveness of control activities. It is difficult for management to reach a conclusion about the effectiveness of control procedures without first implementing appropriate monitoring activities.